80-1101

No. .....

FILED

DEC 31 1980

MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1980

In re U.S. FINANCIAL INCORPORATED,
a Delaware Corp. & Affiliates, *Debtors.*

ROBERT D. KELCE,
Petitioner,

vs.

U.S. FINANCIAL INCORPORATED,
a Delaware corporation, and affiliates,
and SWAN CONSTRUCTORS, INC.,
a California corporation,
Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

William D. Scheid
LAW, SCHEID AND FARABEE
A Professional Corporation
3100 First of Denver Plaza
633 Seventeenth Street
Denver, Colorado 80202
Telephone: (303) 573-4800
Counsel for Petitioner

December 30, 1980

SORG PRINTING COMPANY OF CALIFORNIA, 346 FIRST STREET, SAN FRANCISCO 94105

QUESTION PRESENTED

Whether property to which a bankruptcy reorganization debtor had but bare legal title and no equitable interest when it filed under the Bankruptcy Act, may be liquidated and distributed to general creditors under a reorganization plan?

TABLE OF CONTENTS

	Page
Question Presented	(i)
Court of Appeals Opinion	1
Grounds on Which Jurisdiction Is Invoked	1
Statutory Provisions Involved	2
Statement of the Case	3
Reasons for Granting the Writ	5
1. The Decision of the Court of Appeals Conflicts with this Court's Decision in *Pearlman v. Reliance Insurance Company*, 371 U.S. 132 (1962)	5
2. The Decision Below Raises Significant and Recurring Problems of Considerable Practical Importance in the Administration of Both the Bankruptcy Act and the Bankruptcy Code	8
Conclusion	11
	Following
Appendix	Page 11
	Appendix at
Order (of Bankruptcy Court)	1
Judgment (of Bankruptcy Court)	3
Findings of Fact and Conclusions of Law (Bankruptcy Court)	5
Amendment to Memorandum of Opinion Re: Defendants' Motion for Judgment on the Pleadings or for Summary Judgment (Bankruptcy Court)	11
Memorandum of Opinion Re: Defendants' Motion for Judgment on the Pleadings or for Summary Judgment (Bankruptcy Court)	13
Judgment on Appeal (District Court)	19
Opinion (Court of Appeals)	22
Order (Denying Rehearing (9th Circuit))	42

TABLE OF AUTHORITIES

Cases

Pages

Pearlman v. Reliance Insurance Company, 371 U.S. 132 (1962) 5, 6, 7, 8, 9, 9 n.6, 10

Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939) 4 n.4, 5, 8

In re Telemart Enterprises, Inc., 425 F. 2d 761 (9th Cir. 1975) *cert. denied,* 424 U.S. 969 (1976) 10

Statutes

Former 11 U.S.C. § 104 5

Former 11 U.S.C. § 110 ..... 2, 10

Former 11 U.S.C. § 586 ..... 2, 10

Former 11 U.S.C. § 621 ..... 2, 5

11 U.S.C. § 541 ..... 2, 9

11 U.S.C. § 1129(b)(1) 3, 8

Miscellaneous

Bankruptcy Rules, Part VII 3

Blum & Kaplan, *The Absolute Priority Doctrine,* 41 Chi. L. Rev. 651 (1974) 6

124 Cong. Rec. S 17,413 (October 6, 1978) 9

H. R. Rep. No. 95-595, 95th Cong., 1st Sess. (1978) 9

In the Supreme Court of the United States

OCTOBER TERM, 1980

In re U.S. FINANCIAL INCORPORATED,
a Delaware Corp. & Affiliates, *Debtors.*

ROBERT D. KELCE,
Petitioner,

vs.

U.S. FINANCIAL INCORPORATED,
a Delaware corporation, and affiliates,

and SWAN CONSTRUCTORS, INC.,
a California corporation,
Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

COURT OF APPEALS

The opinion delivered by the Court of Appeals for the Ninth Circuit is not yet reported. The decision of the Bankruptcy Court from which appeal was taken is reported at 3 Bankr. Ct. Dec. (C.F.R.) 507 (July 22, 1977).

GROUNDS ON WHICH JURISDICTION IS INVOKED

The Court of Appeals for the Ninth Circuit delivered its opinion affirming the District Court on October 2, 1980.[1]

1. Herbert J. Solomon, Trustee for Respondents, is the only party to this proceeding whose name is not included in the caption.

Petitioner's Petition for Rehearing was denied by the Court of Appeals by its Order dated November 24, 1980. This Court has jurisdiction to review the judgment of the Court of Appeals by Writ of Certiorari pursuant to 28 U.S.C. § 1254.

STATUTORY PROVISIONS INVOLVED

Former 11 U.S.C. § 110 (§ 70 of the Bankruptcy Act, as amended)

> The trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this Act ....

Former 11 U.S.C. § 586 (§ 186 of the Bankruptcy Act, as amended)

> A trustee, upon his appointment and qualification, shall be vested with such title as a trustee appointed under section 44 of this Act would have.

Former 11 U.S.C. § 621 (§ 221 of the Bankruptcy Act, as amended)

> The judge shall confirm a plan if satisfied that . . . (2) the plan is fair and equitable, and feasible ....

11 U.S.C. § 541(d) (§ 541(d) of the Bankruptcy Code)

> Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . . becomes property of the estate under subsection (a) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

11 U.S.C. § 1129(b)(1) (§ 1129(b)(1) of the Bankruptcy Code)

> Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the Court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

STATEMENT OF THE CASE

The jurisdiction of the District Court was invoked because the issues presented arise under the Bankruptcy Act, as amended.[2]

On and shortly after July 23, 1973, Respondent U.S. Financial Incorporated and various of its subsidiaries, including Respondent Swan Constructors, Inc.,[3] filed petitions for arrangement under Chapter XI of the Bankruptcy Act, (former 11 U.S.C. §§ 701 *et seq.*) in the United States District Court for the Southern District of California. All proceedings were consolidated for joint administration. On August 29, 1975, Petitioner commenced an action in the Bankruptcy Court for the Southern District of California pursuant to Part VII of the Bankruptcy Rules, to reclaim certain real property which Petitioner had transferred to USF in exchange for preferred stock of USF in a trans-

---

2. References to the Bankruptcy Act refer to former 11 U.S.C. §§ 1 *et seq.*, as amended to July 23, 1973, the date on which Respondent U.S. Financial Incorporated filed its Petition under Chapter XI of the Bankruptcy Act. References to the Bankruptcy Code refer to the Bankruptcy Code of 1978 (11 U.S.C. §§ 101 *et seq.*).

3. Hereinafter Respondents U.S. Financial Incorporated and Swan Constructors, Inc., are referred to jointly either as "USF" or "Respondents".

action in which Petitioner relied upon false and misleading financial statements of USF. Subsequently, the USF Chapter XI proceedings were converted to Chapter X proceedings (former 11 U.S.C. §§ 501 *et seq.*), and Herbert J. Solomon was duly appointed and qualified to act as Trustee for the reorganization of the Respondents.

The grounds upon which Petitioner based his claim for reclamation of the real property were:

(i) under California law, Petitioner had the right to rescind the transaction by reason of the fraud of Respondents and that thus Respondents, and later their Trustee, held only bare legal title to the remaining property, which Petitioner beneficially owned; and

(ii) under California law, Respondents, and later their Trustee, held the real property in constructive trust for the benefit of Petitioner by reason of Respondents' fraud.

On May 18, 1977, the Trustee for Respondents moved for Judgment on the Pleadings. The Bankruptcy Court granted Respondents' Motion by Order entered on August 11, 1977. Appendix p. 1. In granting Respondents' Motion, the Bankruptcy Court held that, while under California law, Respondents' fraud would entitle Petitioner to reclaim the real property, nevertheless, the "absolute priority rule" precluded reclamation in Chapter X proceedings.[4] Appendix pp. 10, 18. The Bankruptcy Court confirmed a plan of reorganization which provides for the liquidation of the debtors' property, including the property claimed by Petitioner, and distribution of the proceeds to general creditors. Appendix p. 9.

The District Court for the Southern District of California affirmed the decision of the Bankruptcy Court on July 14,

---

4. The "absolute priority rule" was made applicable to Chapter X reorganization proceedings in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939). The rule is discussed in more detail at pages 5-6, *infra*.

1978, (Appendix p. 19), and the United States Court of Appeals for the Ninth Circuit affirmed the District Court by opinion rendered on October 2, 1980. Appendix p. 22. Petitioner's Petition for Rehearing was denied on November 24, 1980. Appendix p. 42.

REASONS FOR GRANTING WRIT

1. The Decision of the Court of Appeals Conflicts With This Court's Decision in Pearlman v. Reliance Insurance Company, 371 U.S. 132 (1962).

The Court of Appeals held that the absolute priority rule precluded Petitioner's reclamation of the real property on either a rescission or a constructive trust theory. The Court held that, even though the real property was beneficially owned by Petitioner, and Respondents and their Trustee held but bare legal title, the proceeds of the property must be distributed to Respondents' creditors. This holding conflicts with this Court's decision in *Pearlman v. Reliance Insurance Company,* 371 U.S. 132 (1962) (*"Pearlman"*).

Pearlman involved a conflict between state law property rights and § 64 of the Bankruptcy Act (former 11 U.S.C. § 104), which prescribed priorities for distribution of a bankrupt's property in a straight bankruptcy liquidation (former 11 U.S.C. Chapters I-VI). The instant case involves a conflict between state law property rights and Section 221(2) of the Bankruptcy Act (former 11 U.S.C. § 621(2)) which provides that a reorganization plan to be confirmed by a court must be "fair and equitable." This "fair and equitable" requirement has long been held to mean that distributions under a plan of reorganization must comply with the "absolute priority rule." *Case v. Los Angeles Lumber Products Co., supra* n.4. The absolute priority rule requires that a reorganization plan provide that property of a Chapter X debtor be distributed to claimants on

the basis of the claimants' priorities upon involuntary liquidation of the debtor; that is, senior claimants must receive full compensation before junior claimants may participate. Blum & Kaplan, *The Absolute Priority Doctrine,* 41 Chi. L. Rev. 651 (1974). The absolute priority rule governs distributions under reorganization plans and must be satisfied before any plan may be found to be "fair and equitable."

Pearlman set down the rules governing the interplay between state law property rights and Bankruptcy Act distribution rules. This Court held that:

> One argument against the [claimant's claim] is that this controversy is governed entirely by the Bankruptcy Act and that § 64 . . . which prescribes priorities for different classes of creditors, gives no priority to [the claimant's] claim for reimbursement. But the present dispute—who has the property interest in the fund, and how much—is not so simply solved. Ownership of property rights before bankruptcy is one thing; priority of distribution in bankruptcy of property that has passed unencumbered into a bankrupt's estate is quite another.

371 U.S. at 135.

In holding that the absolute priority rule precluded Petitioner from reclaiming the subject real property notwithstanding the fact that the property was beneficially owned by Petitioner, the Court of Appeals clearly contradicted the admonishment of *Pearlman* that "[o]wnership of property rights before bankruptcy is one thing; priority of distribution . . . is quite another." It is clear that under the rule of *Pearlman* Petitioner is entitled to reclaim the subject property. *Pearlman* held that

> "[I]f the [claimant] at the time of adjudication was, as it claimed, either the outright legal or equitable owner of this fund, or had an equitable lien or prior

> right to it, this property interest of the [claimant] never became a part of the bankruptcy estate to be administered, liquidated, and distributed to general creditors of the bankrupt. . . . Consequently our question is not who was entitled to priority in distributions under § 64, but whether the [claimant] had, as it claimed, ownership of, an equitable lien on, or a prior right to this fund before bankruptcy adjudication.

371 U.S. at 136. In the case at bar, the question is not whether Petitioner is entitled to priority in a distribution under a plan governed by the absolute priority rule, but whether Petitioner had equitable ownership or a prior right to the subject real property at the time Respondents filed their Petitions under the Bankruptcy Act.[5] The answer lies not in a rule of priority of distribution but rather in applicable state property law. The Bankruptcy Court's findings and conclusions make it clear that Petitioner had superior title under applicable state law. Appendix at 8, 16.

Pearlman made it clear that two separate questions are involved in any distribution of property under the Bankruptcy Act. First, what property is subject to distribution? Secondly, what are the rules which govern the priority of distribution of property which has been determined to be subject to distribution? The holding below conflicts with *Pearlman* in holding that property equitably owned by Petitioner could be distributed to the general creditors of Respondents. Further, it used the absolute priority rule, which concerns the second question, to decide the first question.

---

5. It appears that had USF been liquidated under the straight bankruptcy liquidation provisions rather than under Chapter X, Petitioner would have long ago had his property.

2. The Decision Below Raises Significant and Recurring Problems of Considerable Practical Importance in the Administration of Both the Bankruptcy Act and the Bankruptcy Code.

The holding of the Court of Appeals reflects a determination of law that has important ramifications for all claimants in a reorganization proceeding who claim that they hold a superior title or interest than that of the debtor in an asset in the possession of the debtor on the date of commencement of proceedings under the Bankruptcy Act. Although the instant case involves a stockholder seeking to reclaim property which he beneficially owned and to which he held a superior title, the principle of law announced by the Court of Appeals goes to the very roots of the interplay between state law property rights and Bankruptcy Act distribution rules. Although it was thought that *Pearlman* clearly outlined the rules by which one determines whether property is subject to distribution to general creditors under the Bankruptcy Act,[6] the Court of Appeals' decision in this case casts a shadow of confusion on *Pearlman* in contradicting it in a Chapter X context. Petitioner is advised by the Administrative Office of the United States Courts that there were 202 Chapter X cases pending at June 30, 1980.

The issue presented here will remain important and recurring, notwithstanding the passage of the new Bankruptcy Code. Just as under the Bankruptcy Act, a plan of reorganization proposed under the Chapter XI Bankruptcy Code (11 U.S.C. § 1101 *et seq.*) must be "fair and equitable." 11 U.S.C. § 1129(b)(1). Under *Case v. Los Angeles*

---

6. Although *Pearlman* was not a Chapter X case, and the Court of Appeals distinguished it for that reason, we note that this Court spoke broadly when it said that "[T]he Bankruptcy Act simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors." 371 U.S. at 135-36.

Lumber Co., supra, n.4, it follows that the "absolute priority rule" will apply and this was the Congressional intent. H. R. Rep. No. 95-595, 95th Cong., 1st Sess. (1978) 413. Since the distribution requirements of the absolute priority doctrine were relied upon by the Court of Appeals to overcome the California law as to title, the decision stands as authority for the identical proposition under the Bankruptcy Code. In enacting the provisions of the Bankruptcy Code relating to title of debtor's estates (11 U.S.C. § 541) Congress intended to reiterate "[T]he general principle that where the debtor holds bare legal title without any equitable interest, that the estate acquires bare legal title without any equitable interest in the property." 124 Cong. Rec. S 17,413 (October 6, 1978). The logic of the holding below applied to the provisions of the Bankruptcy Code would thwart that intention.

Bankruptcy courts are frequently faced with conflicting claims of title to and interest in property of debtors, and this Court has consistently held that such conflicting claims must be resolved before it can be determined whether the property may properly be distributed among general creditors. For the first time since *Pearlman,* a circuit court has held that the conflicting claims of title and interest are not important—even if the claimant has superior title to the property and beneficially owns it, the property can nevertheless be distributed to general creditors.

Thus, where a reorganization debtor holds property as trustee under an express trust agreement, the trust property would be subject to distribution to general creditors because, although the beneficiary of the trust would have a claim of equitable ownership of the property, that claim would be inferior to the claims of secured creditors and no greater than the claims of unsecured creditors by reason of the

erroneous application of the absolute priority rule in the instant case. The question will continue to be raised outside of the context of a trust. For example, the question will frequently arise where a seller of goods seeks reclamation under the Uniform Commercial Code. *See In re Telemart Enterprises, Inc.*, 425 F. 2d 761 (9th Cir. 1975), *cert. denied*, 424 U.S. 969 (1976).

In all such instances, bankruptcy courts nationwide will be presented with the interplay between state law property rights existing before bankruptcy and distribution rules contained in the Bankruptcy Code. *Pearlman* recognized that "such property rights existing before bankruptcy in persons other than the bankrupt must be recognized and respected in bankruptcy." 371 U.S. at 136. In the instant case the appellate court, notwithstanding *Pearlman*, refused to recognize and respect such property rights despite the fact that § 70 of the Bankruptcy Act, applicable by reason of § 186 of the Bankruptcy Act, and *Pearlman* both require such recognition.

Bankruptcy courts and litigants alike need this Court to throw light on the obvious division between the Court of Appeals for the Ninth Circuit and this Court. It appears that the problem was not resolved by *Pearlman*. The prompt resolution of this question will obviously have immediate and recurring importance beyond the Petitioner here, and will affect and guide numerous bankruptcy courts and litigants in resolving conflicting claims to property, in the hands of the debtors when proceedings in bankruptcy reorganization begin.

CONCLUSION

For all of the foregoing reasons, a Writ of Certiorari should issue to review the judgment and opinion of the Ninth Circuit.

Respectfully submitted,

LAW, SCHEID AND FARABEE
A Professional Corporation

By WILLIAM D. SCHEID
William D. Scheid
/s/ Jeffrey L. Beattie
Counsel for Petitioner

3100 First of Denver Plaza
633 Seventeenth Street
Denver, Colorado 80202
Telephone: (303) 573-4800

December 30, 1980

Appendix

THOMAS HENRY COLEMAN, ESQ.
JAYSON BURTON LUMISH, ESQ.
RIFKIND, STERLING & LOCKWOOD,
INCORPORATED
9454 Wilshire Boulevard, 6th Floor
Beverly Hills, California 90212
(213) 278-0970
Attorneys for Herbert J. Solomon, Reorganization Trustee of U. S. Financial and Swan Constructors

United States District Court
Southern District of California

Bankruptcy No. 17007, et al
Complaint No. 21

In re U. S. FINANCIAL INCORPORATED,
a Delaware corporation and Affiliates,
Debtors.

ROBERT D. KELCE,
Plaintiff,

v.

U. S. FINANCIAL INCORPORATED, a Delaware corporation, and Affiliates, and SWAN CONSTRUCTORS, INC., a California corporation,
Defendants.

ORDER

AT SAN DIEGO, CALIFORNIA, THIS 11 DAY OF AUGUST, 1977.

The Motion of Herbert J. Solomon, Reorganization Trustee of defendants U. S. Financial Incorporated and Swan Constructors Inc., for Judgment on the Pleadings or, in the Alternative, for Summary Judgment, having been heard by this Court on June 6, 1977, and the Court having read and considered the files and records of the above-entitled adversary proceeding and having heard the arguments of counsel, plaintiff having appeared by Law, Nagel & Clark, by Jeffrey L. Beattie, Esq., and the Reorganization Trustee having appeared by Rifkind, Sterling & Lockwood, Incorporated, by Jayson Burton Lumish, Esq., and Findings of Fact and Conclusions of Law having been made and filed herewith;

NOW, THEREFORE, IT IS HEREBY ORDERED, ADJUDGED AND DECREED:

That the Motion for Judgment on the Pleadings filed herein by Herbert J. Solomon, Reorganization Trustee of defendants U. S. Financial Incorporated and Swan Constructors, Inc., he and the same hereby is granted, and that the Reorganization Trustee be and he hereby is authorized to sell, dispose of or otherwise deal with that portion of the 939 Coast Boulevard property known commonly as the "Annex," free and clear of any claim of plaintiff based upon any purported right to rescission or reclamation.

/s/ HERBERT KATZ
Herbert Katz, Bankruptcy Judge

United States District Court
Southern District of California

Bankruptcy No. 17007, et al
Complaint No. 21

In re U. S. FINANCIAL INCORPORATED,
a Delaware corporation and Affiliates,
Debtors.

ROBERT D. KELCE,
Plaintiff,

v.

U. S. FINANCIAL INCORPORATED, a Delaware corporation, and Affiliates, and SWAN CONSTRUCTORS, INC., a California corporation,
Defendants.

JUDGMENT

AT SAN DIEGO, CALIFORNIA, THIS 11th DAY OF AUGUST, 1977.

The Motion of Herbert J. Solomon, Reorganization Trustee of defendants U. S. Financial Incorporated and Swan Constructors Inc., for Judgment on the Pleadings or, in the Alternative, for Summary Judgment, having been heard by this Court on June 6, 1977, and the Court having read

and considered the files and records of the above-entitled adversary proceeding and having heard the arguments of counsel, plaintiff having appeared by Law, Nagel & Clark, by Jeffrey L. Beattie, Esq., and the Reorganization Trustee having appeared by Rifkind, Sterling & Lockwood, Incorporated, by Jayson Burton Lumish, Esq., Findings of Fact and Conclusions of Law having been made and filed herewith, and this Court having ordered that the Motion for Judgment on the Pleadings be granted, and good cause appearing therefor;

NOW, THEREFORE, IT IS HEREBY ORDERED, ADJUDGED AND DECREED that Judgment on the Pleadings is hereby entered against Plaintiff and in favor of Defendants on Complaint No. 21.

/s/ HERBERT KATZ
Herbert Katz, Bankruptcy Judge

United States District Court
Southern District of California
Chapter X
No. 17007-K
Complaint No. 21

In re U. S. FINANCIAL, INC., a Delaware corporation, and affiliates, *Debtors.*
ROBERT D. KELCE, *Plaintiff,* v. U. S. FINANCIAL, INC., a Delaware corporation, et al., *Defendants.*

FINDINGS OF FACT AND CONCLUSIONS OF LAW

The Motion of Herbert J. Solomon, Reorganization Trustee of defendants U. S. FINANCIAL, INC., and SWAN CONSTRUCTORS, INC., for Judgment on the pleadings or, in the alternative, for Summary Judgment, having been heard by this court on June 6, 1977, and the court having read and considered the files and records of the above entitled adversary proceeding and having heard the arguments of counsel, plaintiff having appeared by Law, Nagel & Clark, by Jeffrey L. Beattie, Esq., and the Reorganization Trustee having appeared by Rifkind, Sterling & Lockwood, Incorporated, by Jayson Burton Lumish, Esq., the court hereby makes its findings of fact and conclusions of law as follows:

FINDINGS OF FACT

1. In December 1968, plaintiff ROBERT D. KELCE ("KELCE") owned approximately 98 condominium units

known as "939 Coast" in La Jolla, California, together with a two story apartment building adjacent thereto, known as the "Annex."

2. In December 1968, KELCE and defendant U. S. FINANCIAL, INC., ("USF") entered into a contract whereby USF obtained an option to purchase the 939 Coast property for $5 million, payable $1 million down, the balance to be evidenced by a promissory note secured by the property.

3. In or about March 1969, USF offered to purchase the property in exchange for preferred stock.

4. Ultimately the transaction was concluded. USF received the property and KELCE received the consideration he was to receive, which included 300,000 shares of USF Preferred Stock, Series A, and 100,000 shares of USF Preferred Stock, Series B.

5. The Series A stock was to be redeemed at the rate of 60,000 shares per year at a redemption price of $10 per share.

6. Redemptions of the Series A stock were made in 1970, 1971 and 1972. However, no redemptions have been made thereafter and KELCE still owns 120,000 shares of the Series A stock.

7. All other consideration received by KELCE has since been disposed of by him, as has the consideration received by USF, save and except for the property previously described as the "Annex," which has a value of $161,000.00.

8. This action was commenced by plaintiff in order to reclaim that portion of the property and proceeds of the sale thereof which are still in the possession of the Trustee in exchange for that portion of the Series "A" stock which, when valued at his purchase price of $10.00 per share, equals the value which the reclaimed property had on the date he transferred it to defendants.

9. For purposes of this motion it will be assumed that plaintiff is in fact a defrauded shareholder, having acquired his shares in reliance upon a materially false, misleading and fraudulent financial statement.

CONCLUSIONS OF LAW

10. This court has jurisdiction of the parties and of the subject matter of the above entitled adversary proceeding.

11. The issue to be decided, based upon the pleadings on file, is whether a defrauded shareholder, preferred or otherwise, may obtain rescission and reclamation in a Chapter X reorganization of those assets with which he parted which are still in the possession of the defendant.

12. This question divides itself into segments as follows:

(1) Under California law, is the remedy of partial rescission available to this plaintiff.

(2) If so, does the application of the absolute priority rule deny the remedy of rescission and reclamation to plaintiff; and

(3) Does the intervening creditor rule bar the relief sought.

13. Except for applicable bankruptcy considerations, California law governs this transaction.

14. The precise issue here raised is a question of first impression.

15. In California the general rule is that one must rescind all of his contract and may not retain rights which he deems desirable and repudiate the rest.

16. The purpose of rescission is essentially to restore the parties to the *status quo ante*.

17. However, there have been exceptions made to the general rule by which partial rescission, which is what the plaintiff here seeks, is allowed.

18. California Civil Code § 1691(b) provides that a plaintiff need not restore all of the consideration received by him where, as here, the defendant is unable to do so.

19. It has also been so held where, without plaintiff's fault, it is impossible to effect a full rescission.

20. A review of the facts in this case, together with the law of California, has led the court to conclude that this case is one where, absent the bankruptcy proceedings, partial rescission would be a proper remedy.

21. The only way to do equity in this situation is to allow partial rescission and reclamation so the defrauded party can salvage something. To hold otherwise here would be an injustice and countenance fraud.

22. If plaintiff is successful in his rescission action, he would make what otherwise would be at best an unsecured claim into a secured claim. That is, as he presently stands, he is a member of the class of creditors who, because of the hopeless insolvency of defendant, would receive nothing by way of distribution under the "absolute priority rule" as embodied in Section 221(2) of the Bankruptcy Act.

23. If, however, he has a right to rescind and reacquire the property sought in his complaint, then, to that extent he would become a secured creditor and be able to effectuate a larger dividend on his claim than otherwise possible.

24. In the present reorganization proceeding, all creditors and stockholders are victims of a massive fraud.

25. Congress, in enacting Section 221(2), intended in a Chapter X proceeding to differentiate between equity owners and general creditors. The scheme as set forth therein provides for full and complete compensation of each class of claims in descending order before the next class can participate.

26. To comply with that purpose a plan must rank claims beginning with secured creditors, then senior unsecured creditors, then subordinated creditors, and finally shareholders. Consequently any arrangement "by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights" of creditors "come within judicial denunication." *Northern Pacific Railway Co. v. Boyd,* 228 U.S. 482, 505 (1913).

27. While plaintiff KELCE may have acquired his shares for property, rather than money, and in a private transaction, rather than on the open market, he nevertheless is, and remains a shareholder and should not be allowed, in view of the "absolute priority rule," to obtain senior creditor standing merely because a portion of the consideration he paid for his stock is fortuitously still in the possession of the defendant.

28. The court agrees with Professors Slain and Kripke who state, in their article entitled "The Interface Between Security Regulations and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors," 48 N.Y.U.L. Rev. 261, 294 (1973), that

> "Regardless of one's view as to the propriety of parity treatment, it is clear that the resciding [sic] stockholders should not wind up as a secured party. . . . The general creditors should not be further prejudiced by the fortuitous fact that the shareholders can trace the issuer's use of his investment."

29. The Plan of Reorganization in this Chapter X proceeding is a plan of liquidation.

30. The Federal bankruptcy power being paramount and supreme over competing or conflicting State law by virtue of the Supremacy clause of the United States Constitution, the State law must give way.

31. Having determined that rescission and reclamation is not available to plaintiff because of the "absolute priority rule," it is unnecessary to discuss the effect of the "intervening creditor rule."

32. In light of the foregoing, the Motion for Judgment on the Pleadings filed herein by Herbert J. Solomon, Reorganization Trustee of defendants U. S. FINANCIAL, INC. and SWAN CONSTRUCTORS, INC., must be granted.

DATED: AUGUST 11, 1977

/s/ HERBERT KATZ
Herbert Katz, Bankruptcy Judge

United States District Court
Southern District of California

Chapter X
NO. 17007 K
Complaint No. 21

In re
U. S. FINANCIAL, INC., a Delaware corporation, and affiliates,
Debtors.

ROBERT D. KELCE,
Plaintiff.

vs.

U. S. FINANCIAL, INC., et al.,
Defendants.

AMENDMENT TO MEMORANDUM OF OPINION RE: DEFENDANTS MOTION FOR JUDGMENT ON THE PLEADINGS OR FOR SUMMARY JUDGMENT

The Memorandum of Opinion in the above entitled matter, heretofore entered and filed by the court on July 22, 1977, is hereby amended as follows:

1) The paragraph commencing at page 2, lines 19 through 21, is stricken and the following paragraph inserted in its stead:

> This action was commenced by plaintiff in order to reclaim that portion of the property and proceeds of the sale thereof, of the above described transaction, including the "Annex," which are still in the possession of the trustee in exchange for that portion of the Series "A" stock which, when valued at his purchase price of $10.00 per share, equals the value which the reclaimed property had on the date it was transferred to defendants.

The paragraph commencing on page 4 lines 27 through 30 is stricken and the following paragraph inserted in its stead:

> Pursuant to a stipulation entered into by and between plaintiff and defendant, approved by the court on July 20, 1977, plaintiff has the right to contend or prove that he should be classified as a member of Class 5B of the Plan of Reorganization and receive all distributions allocable to him as a member of that class, which, together with Class 5A will receive basically 80/95ths of the 2 million shares issuable under the Plan.

DATED: AUGUST 11, 1977

/s/ HERBERT KATZ
Herbert Katz, Bankruptcy Judge

United States District Court
Southern District of California

Chapter X
NO. 17007-K
Complaint No. 29 [sic]

In re
U. S. FINANCIAL, INC.,
a Delaware corporation and affiliates,
Debtors.

ROBERT D. KELCE,
Plaintiff.

v.

U. S. FINANCIAL, INC., et al.,
Defendants.

MEMORANDUM OF OPINION RE. DEFENDANTS MOTION FOR JUDGMENT ON THE PLEADINGS OR FOR SUMMARY JUDGMENT

The issue to be decided, based upon the pleadings on file, is whether a defrauded shareholder, preferred or otherwise, may obtain rescission and reclamation in a Chapter X reorganization.

FACTS

In December 1968, plaintiff owned approximately 98 condominium units known as "939 Coast" in La Jolla, California, together with a two story apartment building adjacent thereto, known as the "Annex."

In December 1968, plaintiff and U. S. FINANCIAL (USF) entered into a contract whereby USF obtained an option to purchase the 939 Coast property for $5 million,

payable $1 million down, the balance to be evidenced by a promissory note secured by the property.

Subsequently, about March 1969, USF offered to purchase the property in exchange for preferred stock. Ultimately the transaction was concluded. USF received the property and plaintiff received the consideration he was to receive, which included 300,000 shares of USF Preferred Stock, Series A, and 100,000 shares of USF Preferred Stock, Series B.

The Series A stock was to be redeemed at the rate of 60,000 shares per year at a redemption price of $10 per share. Redemptions were made in 1970, 1971 and 1972. None have been made thereafter and plaintiff still owns 120,000 shares of the Series A stock. All other consideration received by plaintiff has since been disposed of by him, as has the consideration received by USF, save and except for the property previously described as the "Annex."

This action was commenced by plaintiff in order to reclaim the "Annex" for the 120,000 shares of Series A stock he still holds, which is now worthless.

For purposes of this motion it is assumed that plaintiff is in fact a defrauded shareholder, having acquired his shares in reliance on a materially false, misleading and fraudulent financial statements. [sic]

Under these facts, in the context of a Chapter X proceeding, may such a defrauded shareholder obtain rescission and reclamation of those of the assets with which he parted which are still in the possession of the defendant?

The question seems to divide itself into segments as follows:

1. Under California law, is the remedy of of [sic] partial rescission available to this plaintiff?

2. If so, does the application of the absolute priority rule deny the remedy of rescission and reclamation to plaintiff, and

3. Does the intervening creditor rule bar the relief sought.

It is undisputed that California law governs this transaction.

It is also undisputed by the parties that the precise issue here raised is a question of first impression.

RESCISSION

In California the general rule is that one must rescind all of his contract and may not retain rights which he deems desirable and repudiate the rest. *Simmons v. California Institute of Technology,* 34 Ca.2d 264, 275 (1949).

The purpose of rescission is essentially to restore the parties to the *status quo ante. Dreiske v. Los Angeles Inv. Securities Corp.,* 13 Ca.App 2d 59 (1936).

However, there have been exceptions made to the general rule by which partial rescission, which is what the plaintiff here seeks, is allowed.

As is stated in California Civil Code § 1691(b) is that plaintiff need not restore all the consideration received by him where, as here, the defendant is unable to do so.

It has also been so held that where, without plaintiffs fault, it is impossible to effect a full rescission. *Stagerman v. Vanderventer,* 57 Ca.App 2d 753 (1943).

Here, the defendant no longer has but a portion of the property transferred to it by plaintiff, having sold most of it in the ordinary course of business, and plaintiff has but a portion of the property given it by defendant, having had a great portion of it redeemed under the mandatory redemption provisions of the Series A stock.

Counsel for both sides argue other authorities for and against the remedy of partial rescission. A review of the facts in this case, together with the law of California, leads one to the conclusion that this case is one, where, absent the Bankruptcy proceeding, partial rescission, that is, return of the consideration still in the hands of the parties, is a proper remedy.

There is no way, at this stage to return everyone to the status quo in existence in 1969. The fact remains however, for purposes of this motion, that plaintiff was defrauded. The only way to do equity in this situation is to allow partial rescission and reclamation so the defrauded party can salvage something. To hold otherwise here would be an injustice and countenance fraud.

Having determined that partial rescission is available, it must next be determined whether the fact that the defendant is in a Chapter X proceeding bars the exercise of the remedy.

If plaintiff is successful in his rescission action, he would make what otherwise would be at best an unsecured claim into a secured claim. That is, as he presently stands, he is a member of the class of creditors who, because of the hopeless insolvency of defendant would receive nothing by way of distribution under the "absolute priority rule" as embodied in §221(2) of the Bankruptcy Act.

If he can establish his fraud claim, he would then fall into the class with all other stock fraud claimants and, under the terms of the plan which has been approved in this case, would share pro rata with those claimants.

If however, he has a right to rescind and reacquire the "Annex," then, to that extent he would become a secured creditor and be able to effectuate a larger dividend on his claim than otherwise possible.

Here all creditors and stock holders are victims of a massive fraud. The Congress, in enacting §221(2) intended, in a Chapter X proceeding, to differentiate between equity owners and general creditors. The scheme as set forth provides for full and complete compensation of each class of claims in descending order before the next class can participate. 6A Collier on Bankruptcy, § 11.06, pp 613-14 (14th Ed. 1972) and citations therein contained.

To comply with that purpose a plan must rank claims begining with secured creditors, then senior unsecured creditors, then subordinated creditors, and finally shareholders. Consequently any arrangement "by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights" of creditors "comes within judicial denunciation." *Northern Pacific Railway Co. v. Boyd,* 228 U.S. 482, 505 (1913).

Plaintiff is a shareholder.

While he may have acquired his shares for property, rather than money, and in a private transaction, rather than on the open market, he nevertheless is, and remains a shareholder and should not be allowed, in view of the "absolute priority rule," to obtain senior creditor standing merely because a portion of the consideration he paid for his stock is fortuitously still in the possession of the defendant.

The court agrees with Slain and Kriple, [sic] *The Interface Between Security Regulations and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors,* 48 N.Y.U.L.Rev. 261 (1973), at p. 294.

> "Regardless of one's view as to the propriety of parity treatment, it is clear that the rescinding stockholders should not wind up as a secured party. . . . The general

creditor should not be further prejudiced by the fortuitous fact that the shareholders can trace the issuer's use of his investment."

The Federal bankruptcy power being paramount and supreme over competing or conflicting State law by virtue of the Supremacy Clause of the United States Constitution, the State law must give way.

Having determined that rescission and reclamation is not available to plaintiff because of the "absolute priority rule," it is unnecessary to discuss the effect of the "intervening creditor rule."

Motion for Judgment on the Pleadings is granted.

Counsel for defendant will prepare and submit an appropriate order and, unless waived, proposed findings of fact and conclusions of law within 7 days from the date hereon, as required by Rule 7 of the Local Rules of the United States District Court for the Southern District of California.

DATED: JULY 22, 1977

/s/ HERBERT KATZ
Herbert Katz, Bankruptcy Judge

United States District Court
Southern District of California

Bankruptcy No. 17007, et al.
Complaint No. 21
Appeal No. 14

In re U. S. FINANCIAL INCORPORATED,
a Delaware corporation, and Affiliates,
Debtors.

ROBERT D. KELCE,
Plaintiff-Appellant,

v.

U. S. FINANCIAL INCORPORATED,
a Delaware corporation, and Affiliates,
and SWAN CONSTRUCTORS, INC., a
California corporation,
Defendants-Appellees.

JUDGMENT ON APPEAL

Plaintiff's appeal from the judgment of the Bankruptcy Court granting defendants' motion for judgment on the pleadings came on regularly for hearing on June 26, 1978, the plaintiff-appellant appearing through Law, Nagel & Clark, by Jeffrey L. Beattie, Esq., and the defendants-appellees appearing through Rifkind, Sterling & Lockwood, Incorporated, by Jayson Burton Lumish, Esq. The court having read and considered the briefs submitted by the respective parties, having further read and considered the files and records of the above-captioned proceedings, and having heard the arguments of counsel, has decided that the bankruptcy court was correct and its decision should be affirmed.

There is no precedent directly addressing the interplay between the absolute priority rule and the common law right of recission in the context of a Chapter X reorganization brought about by massive fraud on the part of the bankrupt. The court is cognizant of the authority cited by appellee but finds that it is not controlling in this particular Chapter X proceeding. In an ordinary bankruptcy, fraud by the bankrupt is the exception, and recovery of property from the bankruptcy estate on a recission/constructive trust theory is justifiable. It is not justifiable, however, when fraud permeates the bankrupt organization and victimizes all who dealt with it.

It must be remembered that there is no right to the imposition of a constructive trust. The constructive trust is an equitable remedy for achieving justice and avoiding unjust enrichment. *Healy v. Commissioner,* 345 U.S. 278 (1953); *Burgess v. Williamson,* 506 F.2d 870 (5th Cir. 1975). It should not be imposed when these equitable goals would not be served. As previously mentioned, this case involves a massive fraud; everyone who did business with United

States Financial: secured creditors, general creditors, and shareholders alike, to some extent have been victims of that fraud. There is no justification for giving this plaintiff preferential treatment due to the fortuitous circumstances that he happened to buy his stock with real property and a piece of that real property happens to still remain in the bankrupt's estate. Such a result would be unjust enrichment of the plaintiff at the expense of the secured and general creditors.

The position of this court and the bankruptcy court is supported by recent articles of leading commentators writing on the subject Slain & Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors,* 48 N.Y.U.L. Rev. 261, 280 (1973); Huff, *The Defrauded Investor in Chapter X Reorganizations: Absolute Priority v. Rule 10b-5,* 50 Am. Bankr. L.J. 197 (1966). These articles are very persuasive and contributed to the court's conclusion that imposition of a constructive trust is not justified in this case.

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the judgment of the Bankruptcy Court granting defendants' motion for judgment on the pleadings is affirmed in all respects.

Dated: July 8, 1978

/s/ GORDON THOMPSON, JR.
Gordon Thompson, Jr., Judge
United States District Court

United States Court of Appeals
for the Ninth Circuit

No. 78-2802
No. 79-3684
Bankruptcy No. 17007

In re
U. S. FINANCIAL INCORPORATED,
a Delaware Corp. & affiliates,

ROBERT D. KELCE,
Plaintiff-Appellant,

vs.

U.S. FINANCIAL INCORPORATED, a Delaware corporation, and affiliates, and SWAN CONSTRUCTORS, INC., a California corporation,
Defendant-Appellee.

OPINION

Appeal from the United States District Court
for the Southern District of California
Gordon Thompson, Jr., Judge Presiding
Argued and submitted July 1, 1980

Before: SKOPIL and FERGUSON, Circuit Judges, and LYDICK,* District Judge

*The Honorable Lawrence T. Lydick, United States District Judge, Central District of California, sitting by designation.

FERGUSON, Circuit Judge

Claimant Robert Kelce appeals from the entry of judgments on the pleadings against him in two proceedings under Chapter X of the Bankruptcy Act,[1] consolidated on appeal. We affirm both judgments.

BACKGROUND

As of December, 1968, Kelce owned a condominium project and an adjacent apartment building in La Jolla, California. That month, Kelce entered into an agreement with the debtor, U.S. Financial Inc.[2] ("USF") whereby USF obtained an option to purchase Kelce's La Jolla properties for $5 million. The option agreement specified that USF would pay $1 million down and would sign a $4 million promissory note payable in five equal annual installments and secured by a deed of trust on the property. Subsequently, USF declined to purchase the property in accordance with the terms set out in the option agreement. Instead, USF offered to purchase the property for $1 million down, $3 million Series A redeemable preferred stock (300,000 shares at $10 per share par value) and $1 million in Series B convertible preferred stock (100,000 shares at $10 per share par value). USF provided Kelce with mate-

---

1. 11 U.S.C.A. § 501 *et seq.* (1970). These actions were brought under the Bankruptcy Act of 1898, as amended. That Act has since been revised by the Bankruptcy Reform Act of 1978, Pub. L. 95-598. Unless otherwise noted, all references to the provision of the Bankruptcy Act contained herein refer to the Bankruptcy Act of 1898, as amended.

2. Shortly after U.S. Financial, Inc. filed its petition for an arrangement under Chapter XI, several of its subsidiaries filed similar petitions. All proceedings were consolidated for joint administration. As used herein, all references to "USF" refer to U.S. Financial, Inc. and its affiliates.

rially false, misleading and fraudulent[3] financial statements for the three years ending December 31, 1968, and Kelce relied on those financial statements in accepting USF's proposal.

Prior to USF's collapse, Kelce converted his Series B stock for approximately $1.5 million, thereby realizing a $500,000 profit. Redemptions of Kelce's Series A preferred stock were made in 1970, 1971 and 1972. No redemptions were made after 1972, and Kelce still owns 120,000 shares of Series A stock.

In 1973, USF filed a petition for arrangement under Chapter XI of the Bankruptcy Act (11 U.S.C.A. § 301 [sic] *et seq.*). At the time of filing, USF still owned four condominium units and the apartment building. The history and collapse of USF is described by Judge Anderson in *In Re U.S. Financial Securities Litigation*, 609 F.2d 411 (9th Cir. 1979).

II. RESCISSION AND RECLAMATION

On August 29, 1975, Kelce filed a complaint for rescission and reclamation of the property still owned by USF. He also sought reclamation of the proceeds of any sale of that property subsequent to the filing of USF's Chapter XI petition.

In late 1975, the Chapter XI proceedings were converted into Chapter X proceedings. Herbert Solomon was ap-

---

3. The courts below, in ruling on the trustee's motions for judgments on the pleadings, were required to accept Kelce's allegations of fact as true. *Austad v. United States*, 386 F.2d 147, 149 (9th Cir. 1967). In reviewing their decision, we also assume the truth of Kelce's allegations, and we therefore assume that Kelce is a defrauded shareholder, having relied on materially false, misleading, and fraudulent financial statements supplied by USF.

pointed and qualified to act as reorganization trustee, and he subsequently filed a motion for judgment on the pleadings or for summary judgment dismissing Kelce's claim. The bankruptcy court sustained the trustee's motion for judgment on the pleadings, holding that although Kelce was entitled to partial rescission and reclamation under California law, the absolute priority rule barred any recovery by Kelce. The district court affirmed and this appeal followed.

A. *Title*

Kelce contends that the courts below erred in holding that his state law right of rescission is superceded by Chapter X of the Bankruptcy Act. He argues that property is not "property of the debtor"[4] and therefore does not pass into the bankrupt estate if the debtor held voidable rather than nondefeasible title to the property at the time of filing.

It is clear, however, that the trustee did acquire title to the property at issue here. Section 186 of the Bankruptcy Act, 11 U.S.C.A. § 586, provides that a Chapter X trustee acquires the same title as a trustee in ordinary bankruptcy receives pursuant to § 70a,[5] 11 U.S.C.A. § 110(a). Contrary to Kelce's assertions, a trustee in ordinary bankruptcy does take title to property to which the debtor held voidable title.

---

4. *See* 11 U.S.C.A. § 616, which provides in pertinent part:
A plan of reorganization under this Chapter—
• • •
(2) may deal with all or any part of the property of the debtor . . . .

5. Section 70(a), 11 U.S.C.A. § 110(a), provides in pertinent part:
The trustee of the estate of a bankrupt . . . upon his . . . appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this title . . . .

but he takes that title *subject* to the defrauded party's claim for rescission and reclamation. *See* 4A *Collier on Bankruptcy* ¶ 70.41 at 483 (14th ed. 1979). "[T]he trustee in bankruptcy *takes title* to the bankrupt's property subject to the retroactive divestment effected by such a rescission." (emphasis supplied). A Chapter X trustee, therefore, does take title to property which is subject to a state law for rescission. There is, however, a critical distinction between Chapter X and Chapter XI proceedings which may affect the ultimate disposition of property taken subject to a rescission claim. That distinction is the necessary application of the absolute priority rule in Chapter X proceedings. *See Protective Committee v. Anderson*, 390 U.S. 414, 441 (1968); *In Re Equity Funding of America Securities Litigation*, 603 F.2d 1353, 1356 n.4 (9th Cir. 1979).

Kelce cites several cases in support of his claim for rescission and reclamation. As the district court noted, however, none of these cases addressed the interaction between the absolute priority rule and the common law right of rescission in Chapter X proceedings. As such, none is controlling here.

In *Pearlman v. Reliance Insurance Co.*, 371 U.S. 132 (1962), the Supreme Court held that the debtor's surety was entitled to recover funds specifically set aside to secure the surety's obligation. The debtor had no *colorable* ownership claim to the funds in question, thus the trustee never obtained title at all. Moreover, *Pearlman* involved an ordinary bankruptcy, and thus the Court was not presented with an opportunity to discuss the absolute priority rule, or a shareholder's right to rescission and reclamation in the context of a Chapter X reorganization. In fact, the case has only once been applied in a Chapter X case, *In re Bruce Construction Corp.*, 217 F. Supp. 926 (S.D. Fla. 1963).

Bruce, like *Pearlman*, involved a surety, and, as in *Pearlman*, the *Bruce* debtor had no colorable claim to title over the fund.

Similarly, none of the Ninth Circuit cases cited by Kelce involved Chapter X proceedings and they therefore do not discuss the absolute priority rule. In *Matter of Paderewski*, 564 F.2d 1353 (9th Cir. 1977), a trustee in ordinary bankruptcy claimed title to a one-half interest in a community property residence. An interlocutory divorce decree, which had not been appealed and which therefore had become final, had not awarded each party a one-half interest in the residence. Since the bankrupt did not have a one-half interest, the trustee did not receive a one-half interest. Again this was not a Chapter X case. Moreover, the bankrupt clearly did not have title to one-half of the property in issue, and neither, therefore, did the trustee. In contrast, USF did have title to the property in issue here, however defective, and the trustee was vested with that title.

In re Forester, 529 F.2d 310 (9th Cir. 1976), involved the subrogation of a second lien holder's claims to collateral to those of a first lien holder. This court made clear that the trustee in ordinary bankruptcy is vested with the bankrupt's title at the moment of bankruptcy. *Id.* at 316. Our holding is not inconsistent with that maxim.

In re Telemart Enterprises, Inc., 425 F.2d 761 (9th Cir. 1975), *cert. denied*, 424 U.S. 969 (1976), concerned reclamation under the Uniform Commercial Code by a seller of goods to a bankrupt purchaser. While we held that a seller could reclaim goods when a bankrupt received voidable title, we were not faced with a Chapter X reorganization and thus did not have to resolve the absolute priority issue. As discussed below, that rule changes the focus of our in-

quiry and mandates that we refuse to permit Kelce to reclaim the property and proceeds at issue.

B. *The Absolute Priority Rule*

The Supreme Court has long recognized that a reorganization plan cannot be "fair and equitable," as it must be before it can be approved[6] or confirmed,[7] if it fails to comply with the absolute priority rule. *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 115-19 (1939); *Protective Committee v. Anderson, supra,* 390 U.S. at 441. This rule requires that

> [b]eginning with the topmost class of claims against the debtor, each class in descending rank must receive full and complete compensation for the rights surrendered before the next class below may properly participate.

6A *Collier on Bankruptcy,* ¶ 11.06 at 210-11 (14th ed. 1979) (citations omitted).

We cannot square the absolute priority rule with Kelce's claim for rescission and reclamation. Were we to allow his claim, we would be permitting Kelce to transform his claim as a defrauded shareholder into a secured claim, in derogation of the rights of senior classes and in violation of the absolute priority rule.

The absolute priority rule is designed to vindicate the reasonable expectations formed by claimants when their

---

6. *See* section 174, 11 U.S.C.A. § 574, which provides in pertinent part:

> . . . the judge shall enter an order approving the plan or plans which in his opinion comply with the provisions of section 616 of this title, and which are fair and equitable, and feasible . . . .

7. *See* section 221, 11 U.S.C.A. § 621, which provides in pertinent part:

> The judge shall confirm a plan if satisfied that—
> • • •
> (2) the plan is fair and equitable, and feasible . . . .

investments or loans were made. *Matter of Stirling Homex Corp.*, 579 F.2d 206, 214 (2d Cir. 1978), *cert. denied*, 439 U.S. 1074 (1979); Slain & Kripke, The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Security Holders and the Issuer's Creditors, 48 N.Y.U. L.Rev. 261, 286-87 (1973) ("Slain & Kripke"); Huff, The Defrauded Investor in Chapter X Reorganizations: Absolute Priority v. Rule 10b-5, 50 Am. Bankr. L.J. 197, 204 (1976); Note, The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations, 87 Harv. L.Rev. 1786, 1790 (1974). In the instant case, those expectations will not be vindicated—instead, they will be violated—by allowing rescission and reclamation. Kelce is in reality seeking relief from the general unsecured creditors of the corporation. Because of USF's insolvency and ultimate liquidation, the percentage which the general creditors would realize would be reduced were Kelce allowed to rescind and reclaim. The absolute priority rule will not tolerate this eventuality. *Matter of Stirling Homex Corp., supra*, 579 F.2d at 213; *Scott v. Abbott*, 160 F.2d 573, 581 (8th Cir.), *cert. denied*, 212 U.S. 571 (1908).

Professors Slain and Kripke have analyzed the expectations of shareholders and creditors. They point out that shareholders accept two risks: the risk of business insolvency and the risk of illegality in securities issuance. General creditors also accept the risk of insolvency, but they expect that their claims will be given priority in the event of bankruptcy. The expectation of priority is implicit in their contracts with the issuer. *Id.* at 286. Shareholders bargain for equity-type rewards in exchange for equity-type risks, but general creditors do not:

> In theory, the general creditor asserts a fixed dollar claim and leaves the variable profit to the stockholder;

> the stockholder takes the profit and provides a cushion of security for payment of the lender's fixed dollar claim. The absolute priority rule reflects the different degree to which each party assumes a risk of enterprise insolvency; no obvious reason exists for reallocating that risk.

Slain & Kripke, *supra,* 48 N.Y.U. L.Rev. at 286-87.

Kelce argues that he did not bargain for equity type risks because he received preferred stock. We note, however, that Kelce sold his Series B stock at a profit of $500,000. While Kelce lost money on his transactions with USF taken as a whole, he clearly took advantage of his shareholder position in converting his Series B stock. We will not allow Kelce to benefit from his shareholder status when he may opt out of that status when he choses. We note that "[w]hen a corporation becomes bankrupt, the temptation to lay aside the garb of a stockholder, on one pretense or another, and to assume the role of a creditor, is very strong, and all attempts of that kind should be viewed with suspicion." *Newton National Bank v. Newbegin,* 74 F. 135, 140 (8th Cir. 1896), *cited in Matter of Stirling Homex Corp., supra,* 579 F.2d at 213. Moreover, we view the Series B transaction as an indication of Kelce's gaining equity-type rewards, and therefore as an indication of his acceptance of equity-type risks.

It is also appropriate to impose the risk of illegality in securities issuance on shareholders, even though their investment may be based on an inaccurate picture of the corporation garnered from false financial statements.

> When the rescission right is enforced in bankruptcy or reorganization . . . the effect is to allocate [the risk of illegality in securities issuance] to general creditors. It is difficult to conceive of any reason for shifting even

> a small portion of the risk of illegality from the stockholder, since it is to the stockholder, and not to the creditor, that the stock is offered.

Slain & Kripke, *supra*, 48 N.Y.U. L.Rev. at 288.

This scheme of risk allocation is particularly appropriate in the instant case. Initially, every creditor and stockholder was victimized by the massive fraud perpetrated by USF.[8] In view of the extent of the fraud, it is equitable to impose the risks of insolvency and illegality on those whose investment, by its very nature, is a risky one.[9] Secondly, as noted by the bankruptcy judge in his conclusions on Kelce's claim for parity with general unsecured creditors,[10] Kelce's transactions presented USF with an opportunity to perpetrate its fraud:

> Had the transaction been concluded as originally structured, that is as a sale on a promissory note secured by a Deed of Trust on the property sold, USF would have shown the value of the property on the asset side subject to the liability on the note. Here however, because of the exchange of the property for stock, it made it possible for USF to show the asset free of encumbrances and in addition USF had the ability to show on its capital contribution side the share[s] of stock which could have misled creditors into thinking additional capital had been contributed. In other words, Kelce gave USF the opportunity (whether it used it or not) to flail with a double edged sword in preparing its financial statements.

---

8. *See* Huff, The Defrauded Investor, *supra*, 50 Am. Bankr. L. J. at 202-03 for a discussion of USF's pre-petition activities.

9. Moreover, it would be manifestly unfair, in light of the extent of the fraud here, to allow Kelce to obtain secured creditor status merely because he received stock for real property and a portion of that property remained in USF's possession at the time of filing.

10. See discussion *infra*.

As between the creditors and Kelce, then, Kelce is the lesser innocent, and Kelce should not be allowed to reclaim the property at issue at the senior creditors' expense.

Based on the above analysis, we conclude that the absolute priority rule would be rendered meaningless were we to allow Kelce to rescind and reclaim.[11] The context of the

---

11. Kelce also points out that the commentators cited by the courts below stress the rehabilitative aspects of Chapter X reorganization plans in formulating their conclusions. He argues that the rationales relied on by those commentators do not apply to a Chapter X plan of reorganization the goal of which is liquidation rather than rehabilitation. We decline to make that distinction. The term "reorganization plan" encompasses both plans which envision rehabilitation and those whose goal is liquidation. *See, e.g., United States v. Key*, 397 U.S. 322, 323 (1970): "The [reorganization] plan, an atypical one for a corporate reorganization, does not contemplate the continued existence of the debtor as a going concern, but amounts in substance to a liquidation." Other courts have consistently noted that a Chapter X reorganization plan may provide for liquidation and, if so, the same rules are to be applied as would be were rehabilitation the ultimate goal. Appellants in *Banker Life & Casualty Co. v. Kirtley*, 338 F.2d 1006 (8th Cir. 1964), for example, urged that ordinary bankruptcy provisions be applied in a Chapter X reorganization which envisioned complete liquidation. The court disagreed, recognizing that "Chapter X contains numerous provisions not applicable to conventional bankruptcies," *id.* at 1009, including § 216(10), 11 U.S.C.A. § 616(10), which allows liquidation.

In addition, the eventual outcome of Chapter X proceedings may not be clear at their outset. The reorganization trustee involved in *Matter of Stirling Homex Corp., supra*, 579 F.2d 206, for example, "originally intended to formulate a plan of reorganization under which Homex would continue operations. Borrowing proved impossible, however, as did merger with or acquisition by a financially sound company. He thus began the Herculean task of liquidating Homex's assets." *Id.* at 209 n.4. It might well prove impossible to reorganize a corporation were we to provide for the application of different rules and standards to plans providing for rehabilitation than we require for plans providing for liquidation. A trustee in a *Homex* situation, where the goal of the plan changed over time, would then have to comply with two different sets of standards. Such confusion is unwarranted.

Finally, as we have noted, the absolute priority rule was designed to reward expectations. Those expectations are formed at the time

instant case is crucial to our holding; when all are defrauded, it is manifestly unfair to allow one shareholder to benefit from that fraud at the others' expense.

III. PARITY WITH GENERAL UNSECURED CREDITORS

In the second case before this court, Kelce contends that he deserves parity with general unsecured creditors since he is a preferred shareholder asserting fraud claims. We disagree and affirm the courts below.

Kelce filed a proof of claim in February, 1976, after USF's Chapter XI proceedings were converted to Chapter X proceedings. The claim, as later amended, averred that Kelce had been defrauded by USF in the sale of USF's preferred shares to him. Kelce sought general unsecured creditor status for the difference in value between the price paid for the Series A stock and the value of the unredeemed shares. (If Kelce were granted parity with the general unsecured creditors, he would receive compensation far in excess of that he would receive as part of the class which includes defrauded shareholders.)

The trustee subsequently filed a reorganization plan which contemplated the liquidation of USF. As amended, the plan divides USF's creditors and stockholders into several classes. Only three of these classes are relevant to our discussion: Class 5B, which includes general unsecured creditors' claims, Class 6, which includes defrauded subordinated debenture holders' claims, and Class 7, including

---

of investment or loan, and by definition are not affected by the ultimate goal of a reorganization plan. We would do violence to the provisions of Chapter X were we to recognize such a liquidation-rehabilitation distinction, and we decline to do so.

defrauded shareholder claims.[12] Classes 5B and 6 were created as a result of a compromise, which provided that the defrauded equity holders were to accept a lower rank than the general unsecured creditors. In return, they were relieved of their burden of proving that they were actually defrauded. Kelce did not participate in these negotiations, and he subsequently objected to approval of the plan. Kelce then entered into a stipulation with the trustee which provided that no provision of the plan would prevent Kelce from obtaining Class 5B status.[13] The plan was confirmed, Kelce filed an amended claim for $1,837,155, and the trustee objected.

Both the bankruptcy court and the district court below held that Kelce is properly a member of Class 7. We agree.

---

12. A "creditor" for purposes of the Bankruptcy Act is a "holder of any claim," § 106(4), 11 U.S.C.A. § 506(4). Claims are defined to "include all claims of whatever character against a debtor or its property, *except stock*, whether or not such claims are provable under section 103 of this title and whether secured or unsecured, liquidated or unliquidated, fixed or contingent," § 106(1), 11 U.S.C.A. § 506(1) (emphasis supplied). The reorganization plan for the liquidation of USF, as approved by the bankruptcy court, provides that the defrauded shareholders are creditors. For purposes of this opinion we assume, without deciding, that defrauded shareholders can be creditors. *See Matter of Stirling Homex Corp., supra,* 579 F.2d at 212.

13. The stipulation provides in pertinent part:

> Herbert J. Solomon, the duly qualified and acting Trustee . . . and Robert D. Kelce . . . by their respective undersigned counsel, hereby stipulate and agree as follows:
>
> 1. Approval of the Trustee's Restated Amended Consolidated Plan of Reorganization . . . is without prejudice to, or waiver of, the right of Kelce to contend or prove that Kelce should be classified as a member of Class 5B of the Plan and that he should receive all distributions allocable to him as a member of Class 5B.
>
> 2. Paragraph 1 of this Stipulation is meant by the parties to remove any provision of the Plan as a defense to the possible change of classification contemplated thereby and shall not be construed as a waiver by the Trustee of any defenses he may otherwise have to such classification change.

Section 197 of the Bankruptcy Act, 11 U.S.C.A. § 597, requires the bankruptcy judge to "fix the division of creditors and stockholders into classes according to the nature of their respective claims and stock." This provision "accords the court a broad latitude in classification of creditors, and classifications should be based on substantial differences in the nature of claims." *Scherk v. Newton,* 152 F.2d 747, 751 (10th Cir. 1945). The requirement that classes be fixed "according to the nature of their respective claims" requires courts to recognize differences in the rights of creditors which mandate differences in treatment. *Matter of Stirling Homex Corp., supra,* 579 F.2d at 211, *citing Scherk v. Newton, supra,* 152 F.2d at 750.

Kelce argues that the absolute priority rule has nothing to do with membership in a class of creditors. We disagree. The absolute priority rule would be rendered meaningless if inferior claimants were classified with superior claimants. Courts would then have no basis for ranking claims as "senior" or "junior." It is true that reorganization courts are

> given a discretionary power of classification to be exercised as the exigencies of each individual case require.
> • • •
>
> Nevertheless, the power of the reorganization court thus broadly defined has certain limits which are always present. The foremost of these is the "fixed principle" or "absolute priority" rule of the *Boyd* case which governs all reorganization plans in determining whether they are fair and equitable. This means that in classifying the various claims and interests, the classes established must be accorded the priority rank to which their claims and interests against the estate entitle them, *and the principle of absolute priority may not be violated by any scheme of classification which places claimants of different rank in the same category for treatment.*

6 *Collier on Bankruptcy* (Pt. 2) ¶ 9.10 at 1596-97 (14th ed. 1979) (emphasis supplied).

As discussed in Section II, *supra,* the nature of Kelce's claim is significantly different from that of a general unsecured creditor. Kelce, for example, realized a $500,000 profit on the sale of his Class B preferred stock. As the bankruptcy judge below noted, Kelce's interest

> smacks of an equity investment with the gains attendant thereto . . . .
>
> Kelce's position appears to be that he was satisfied to be an equity holder while things were going well, but now that things have turned sour, he wants another position, that of a general creditor.
>
> That position seems patently unfair and inequitable to the general creditor body.

Kelce cannot be included in Class 5B because of the nature of his claim. It is true that the reorganization plan itself designates defrauded shareholders as creditors. But all unsecured creditors need not be classified together. In fact, they may not be classified together if certain claims "are of such a nature as to give them some right of priority or preference over other claimants. These creditors, then, must be separately classified and accorded the priority to which they are entitled." 6 *Collier on Bankruptcy* (Pt. 2) ¶ 9.13 at 1620-21 (14th ed. 1979).

Kelce contends that his claim properly belongs in Class 5B by virtue of the Supreme Court's decision in *Oppenheimer v. Harriman National Bank,* 301 U.S. 206 (1937). He argues that his inclusion in Class 7 therefore necessarily constituted subordination without cause. We agree with the Second Circuit, however, in concluding that *Oppenheimer* is not controlling here. *See Matter of Stirling Homex Corp., supra,* 579 F.2d at 211 n.8. Furthermore, we

hold that Kelce's Class 7 classification was proper[14] and that there was, therefore, no exercise of the courts' powers of equitable subordination.[15]

The *Oppenheimer* claimant bought stock in a bank in 1930. The bank subsequently closed, and, during liquidation, Oppenheimer sued for rescission based on fraud. He obtained a money judgment, but the Second Circuit ordered that he not be paid until all creditors' claims had been satisfied. The Supreme Court reversed, holding that Oppenheimer's claim was entitled to parity with other unsecured creditors' claims. *Oppenheimer, supra,* 301 U.S. at 215. Significantly, the *Oppenheimer* decision was based on the National Bank Act, 12 U.S.C. § 1 *et seq.,* which requires

---

14. This court has upheld the classification of rescission claims with claims of "holders of promissory notes which are unsecured . . . ." *In re Los Angeles Land & Investments, Ltd.,* 282 F. Supp. 448, 454 (D. Hawaii 1968), *aff'd,* 447 F.2d 1366 (9th Cir. 1971) (per curiam). That case involved land sales based upon unregistered publicly offered contracts, and is easily distinguishable from the instant case. The rescission claims in *Los Angeles Land* were held by those who had contracted to purchase land, and not by shareholders who had acquired equity. Moreover, the *Los Angeles Land* trustee recommended, and the courts approved, the classification at issue there. We have noted that reorganization courts have broad discretion in classifying creditors and stockholders. We concluded that the *Los Angeles Land* classification was acceptable based absolute priority rule. In the instant case, the trustee carefully recommended separate classification for defrauded shareholders and general unsecured creditors, and we have concluded that that classification is the appropriate one.

15. We have not subordinated Kelce's claim, nor have the courts below. Kelce is responsible for his classification here. Kelce, unlike the general unsecured creditors, had control over the manner in which he was paid for his property. As noted above, Kelce provided USF with an opportunity to further perpetrate its fraud. Furthermore, Kelce converted his Class B stock at a sizable profit, thereby accepting the rewards of an equity holder. By originally accepting preferred stock, Kelce accepted a position subordinate to that of general creditors. We would be unjustifiably subordinating the *ordinary unsecured creditors* were we to include Kelce's claim within Class 5B.

"ratable" and not "fair and equitable" distribution. Two years after the *Oppenheimer* decision, the Supreme Court held that the "fair and equitable" standard required adherence to an absolute priority rule in *Case v. Los Angeles Lumber Products Co., supra,* 308 U.S. 106 (1939).[16] Our conclusion that *Oppenheimer* is not controlling here is bolstered by two subsequent Supreme Court opinions in which the question of defrauded shareholder's proper ranking was left unanswered. *See Protective Committee v. Anderson, supra,* 390 U.S. at 423 & n. 8, 453; *Tcherepnin v. Knight,* 389 U.S. 332, 346 (1967). Moreover, as discussed *infra,* there would have been no compromise necessary here had this question been authoritatively resolved by *Oppenheimer.*

Given the significant differences set out above between Kelce's claim and the claims of the general unsecured creditors, we cannot hold that the classification scheme devised here violates § 197 or § 221(2). We are not holding that a defrauded shareholder may never be classified with general unsecured creditors. We merely hold that, given the particular facts of this case, the absolute priority rule would be violated if Kelce were granted Class 5B status.[17]

---

16. The court in *Case* applied the "fixed principle" of *Northern Pacific Railway Co. v. Boyd,* 328 U.S. 482 (1913).

17. At oral argument, Kelce's counsel argued that the reliance by the courts below on the absolute priority rule was misplaced. If that rule bars all equity holders from being classified with general unsecured creditors, he argued, there would have been no basis for a compromise here. We disagree. The question of whether defrauded shareholders may achieve parity with ordinary unsecured creditors was clearly an open question at the time of compromise. *See Protective Committee v. Anderson, supra,* compromise. *See Protective Committee v. Anderson, supra,* 390 U.S. at 423 & n.8, 453; *Tcherepnin v. Knight, supra,* 389 U.S. at 346. (In fact, Kelce's argument that *Oppenheimer* mandates the equal treatment of defrauded shareholders and general unsecured creditors, if valid, would also negate any reason for compromise.) *See also Matter of*

We note again the massive fraud which victimized every USF shareholder and creditor. We could not countenance a classification scheme whereby Kelce would, by virtue of the fraud here, be allowed to share equally with defrauded unsecured creditors who expected priority in the event of insolvency. Since the relative expectations of the parties would not be realized were Kelce included in Class 5B, the absolute priority rule will not allow us to permit that classification.

The Second Circuit recently reached much this same conclusion in *Matter of Stirling Homex Corp., supra,* 579 F.2d 206, when it held that defrauded shareholders could fairly and equitably be classified below general unsecured creditors. The court relied on several theories in reaching its conclusion: it stressed the necessity of classifying claims according to the priority to which they are entitled; the varying expectations of equity holders and of creditors, and the general equity powers of reorganization courts.

Equity Funding Corp. of America, 416 F.Supp. 132, 151 (C.D. Cal. 1975):

> There is authority for the proposition that a fraud claim, even if based upon stock acquisition, is on a parity with general unsecured claims in a reorganization proceeding. Acceptance of this proposition would probably violate the expectations of all parties, because stockholders ordinarily are entitled to no recovery from an insolvent company.
> This bona fide issue has not been authoritatively resolved.

In light of this dispute, it was not unreasonable for the trustee and the other equity holders to negotiate a compromise. Trustees have long utilized compromises in avoidance of litigation, *Protective Committee v. Anderson, supra,* 390 U.S. at 424, and the compromise negotiated here was correctly held to satisfy the requisite "fair and equitable" standard.

Furthermore, as outlined above, we are not holding that defrauded shareholders may never be classified with general unsecured creditors. Our holding is limited to the facts of this case.

Id. at 213-14.[18] While we do not decide the instant case on equity grounds, we find support for our holding in the Second Circuit's recognition of the importance of recognizing differences in expectations when classifying claims against the debtor.

An argument might be made that Kelce, as a defrauded preferred shareholder, was entitled to priority over the defrauded common shareholders. In *Petition of Portland Electric Power Co.*, 162 F.2d 618 (9th Cir.), *cert. denied*, 332 U.S. 837 (1947), for example, we held that the rights of preferred stockholders must be recognized in bankruptcy proceedings. *Id.* at 622. The stockholders in *Portland*, however, were classified as stockholders, not as creditors whose claims were based on fraud. Moreover, Kelce is not arguing that he is entitled to a different classification from that of defrauded common shareholders; he contends that he more properly belongs in Class 5B than in Class 7. As presented to us, our task is to determine which of those two classes should more properly include Kelce.[19] As such, we have

---

18. This court noted the *Stirling Homex* decision in *In re Equity Funding of America Securities Litigation*, 603 F.2d 1353 (9th Cir. 1979). While we neither rejected nor approved the decision, we characterized its holding that defrauded shareholders should be classified beneath ordinary unsecured creditors as the "majority rule." *Id.* at 1356 n.5.

19. At oral argument, petitioner's counsel suggested that preferred shareholders are more similar to subordinated debenture holders than they are to common shareholders. This argument was not presented to the courts below and is not properly before us. In addition, we note that the stipulation signed by Kelce and the trustee allowed Kelce to attempt to show that he should have been included in Class 5B, not in Class 6.

In addition, counsel for Kelce argued that the rulings of the courts below amounted to a rescission of the stipulation between the trustee and Kelce. This argument borders on the frivolous.

The stipulation provided that Kelce could attempt to prove that he more properly belonged in Class 5B. He was allowed to make that attempt; as such, he was not precluded from making an attempt by virtue of an existing, approved plan. The stipulation did not mandate that Kelce be included in Class 5B; it merely allowed him to raise the claim.

determined that Kelce was correctly placed in Class 7. In addition, we note that due to USF's insolvency, none of the equity holders would receive any compensation were it not for the compromise negotiated by the trustee and the other equity holders. Classifying Kelce with the common shareholders, therefore, does not do violence to the provisions of the Bankruptcy Act.

Finally, we note that Congress has now expressly provided that defrauded shareholders' claims be classified below those of general unsecured creditors. See § 510 of the Bankruptcy Reform Act of 1978, 11 U.S.C.A. § 510(b) (1979).[20]

Accordingly, we AFFIRM.

---

20. Section 510 of the Bankruptcy Reform Act of 1978 provides in pertinent part:

> (b) Any claim for recission [sic] of a purchase or sale of a security of the debtor or of an affiliate or for damages arising from the purchase or sale of such a security shall be subordinated for purposes of distribution to all claims and interests that are senior or equal to the claim or interest represented by such security.
>
> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
>
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest . . . .

Filed
Nov. 24, 1980
Richard Deane
Clerk U.S. Court of Appeals.

In the
United States Court of Appeals
For the Ninth Circuit

No. 78-2802
Bankruptcy No. 17007

In re U. S. FINANCIAL INCORPORATED,
a Delaware Corp. & Affiliates,
Debtors.

ROBERT D. KELCE,
Plaintiff-Appellant,
vs.
U. S. FINANCIAL INCORPORATED,
a Delaware corporation, and affiliates,
and SWAN CONSTRUCTORS, INC., a California corporation,
Defendant-Appellee.

ORDER

Before: SKOPIL and FERGUSON, Circuit Judges, and LYDICK,* District Judge

The panel as constituted in the above case has voted to deny the petition for rehearing. Judges Skopil and Ferguson voted to reject the suggestion for rehearing en banc and Judge Lydick made no recommendation regarding the en banc request.

The full court has been advised of the suggestion for en banc rehearing and no judge of the court has requested a vote on the suggestion for rehearing en banc.
Fed. R. Ap. P. 35(b).

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

*Honorable Lawrence T. Lydick, United States District Judge, Central District of California, sitting by designation.

APR 10 1
ALEXANDER L. S
CLERK

No. 80-1101
IN THE

Supreme Court of the United States

October Term, 1980

In re U. S. FINANCIAL INCORPORATED, A Delaware corporation, and Affiliates,

Debtors.

ROBERT D. KELCE,

Petitioner,

vs.

U. S. FINANCIAL INCORPORATED, a Delaware corporation, and Affiliates, and SWAN CONSTRUCTORS, INC., a California corporation,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

WILLIAM G. WILSON, ESQ.,
RIFKIND & STERLING, INCORPORATED,
9454 Wilshire Blvd., Sixth Floor,
Beverly Hills, Calif. 90212,
(213) 278-0970,
Counsel for Respondents.

Parker & Son, Inc., Law Printers, Los Angeles. Phone 724-6622

TABLE OF CONTENTS

	Page
Statement of the Case	1
Certiorari Should Be Denied	4
1. There Is Absolutely No Conflict Whatsoever Between the Decision of the Court of Appeals and This Court's Decision in Pearlman v. Reliance Insurance Company, 371 U.S. 132 (1962)	4
2. No Significant or Recurring Problems of Practical Importance Are Presented by This Case Since Congress, by Enacting Section 510(b) of the Bankruptcy Reform Act of 1978, 11 U.S.C. § 510(b), Has Now Statutorily Provided for the Result Reached by the Court of Appeals Below	6
Conclusion	8

TABLE OF AUTHORITIES

Cases	Page
Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939)	2
Northern Railway Co. v. Boyd, 228 U.S. 482 (1913)	2
Pearlman v. Reliance Insurance Company, 371 U.S. 132 (1962)	4, 5
Rice v. Sioux City Memorial Parks Cemetery, 349 U.S. 70 (1955)	8
Stirling Homex Corp., Matter of, 579 F.2d 206 (2d Cir. 1978), cert. denied sub nom. Jezarian v. Riache, 439 U.S. 1074 (1979)	5, 6
Statutes	
11 U.S.C. §§ 501 et seq.	2
11 U.S.C. § 510(b)	6, 7, 8
Former 11 U.S.C. § 621(2)	2
Miscellaneous	
6A Collier on Bankruptcy, ¶ 11.06 (14th Ed. 1977)	2
Huff, The Defrauded Investor in Chapter X Reorganizations: Absolute Priority v. Rule 10b-5, 50 Am. Bankr. L. J. 197 (1976)	6
Senate Report No. 95-989, 1978 U.S. Congressional and Administrative News, p. 5860	7
Slain & Kripke, The Interface Between Securities Regulation and Bankruptcy — Allocating the Risk of Illegal Securities Issuance Between Security Holders and the Issuer's Creditors, 48 N.Y.U.L. Rev. 261 (1973)	5

No. 80-1101
IN THE

Supreme Court of the United States

October Term, 1980

In re U. S. FINANCIAL INCORPORATED, A Delaware corporation, and Affiliates,

Debtors.

ROBERT D. KELCE,

Petitioner,

vs.

U. S. FINANCIAL INCORPORATED, a Delaware corporation, and Affiliates, and SWAN CONSTRUCTORS, INC., a California corporation,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

Statement of the Case.

On August 29, 1975, petitioner Robert D. Kelce ("Kelce") commenced suit in the Bankruptcy Court for the Southern District of California against respondents U. S. Financial Incorporated and Swan Constructors, Inc. (hereinafter referred to collectively as "USF") seeking partial rescission of a 1969 sales transaction pursuant to which Kelce received $5 million in cash and preferred stock from USF in exchange

for certain condominium and apartment units owned by Kelce in La Jolla, California.[1] Kelce's action, which asserted claims purportedly arising under the federal securities laws (Rule 10b-5) and the California fraudulent deceit statutes, sought to reclaim from USF those condominium and apartment units in which USF retained an interest at the time of suit.

On May 18, 1977, the Reorganization Trustee for respondents moved for judgment on the pleadings, or, in the alternative, for summary judgment, on the grounds, in part, that the "absolute priority rule" applicable in Chapter X proceedings, *see Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), served to bar an allegedly defrauded stockholder, such as petitioner Kelce, from reclaiming and withdrawing assets from the estate which would otherwise be used to satisfy the more senior claims of the general unsecured creditors.[2] On July 22, 1977, the Bankruptcy

---

[1]On or shortly after July 23, 1973, respondent U. S. Financial Incorporated and various of its subsidiaries and affiliates, including respondent Swan Constructors, Inc., filed petitions for arrangement under Chapter XI of the federal Bankruptcy Act (former U.S.C. §§ 701, *et seq.*) in the United States District Court for the Southern District of California. Subsequently, in late 1975, these proceedings were converted into reorganization proceedings under Chapter X of the Bankruptcy Act (former 11 U.S.C. §§ 501, *et seq.*,) and Herbert J. Solomon was duly appointed and qualified to act as Reorganization Trustee for respondents.

[2]The "absolute priority rule" requires that, in Chapter X proceedings,

> "[b]eginning with the topmost class of claims against the debtor, each class in descending rank must receive full and complete compensation for the rights surrendered *before* the next class below may properly participate." 6A *Collier on Bankruptcy*, ¶ 11.06 at 210-11 (14th Ed. 1977) (citations omitted). (Emphasis supplied.)

Thus, to comply with the "absolute priority rule," a reorganization plan, to be "fair and equitable" under Section 221(2) of the Bankruptcy Act (former 11 U.S.C. § 621(2)), must rank claims on a scale of priority beginning with secured creditors, then senior unsecured creditors, then subordinated creditors, and finally shareholders. *Id.* at 211-14. Consequently, any arrangement "by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights" of creditors "comes within judicial denunciation." *Northern Railway Co. v. Boyd*, 228 U.S. 482, 505 (1913).

Court granted respondents' motion (Appendix to Petition for Writ of Certiorari (hereinafter "Appendix"), p. 13), and judgment on the pleadings was formally entered against petitioner on August 11, 1977 (Appendix, p. 3). Subsequently, the decision of the Bankruptcy Court was affirmed by the United States District Court for the Southern District of California on July 8, 1978 (Appendix, p. 19), and the decision of the District Court was thereafter affirmed by the United States Court of Appeals for the Ninth Circuit on October 2, 1980, the Court holding that

> "We cannot square the absolute priority rule with Kelce's claim for rescission and reclamation. Were we to allow his claim, we would be permitting Kelce to transform his claim as a defrauded shareholder into a secured claim, in derogation of the rights of senior classes and in violation of the absolute priority rule.
>
> "The absolute priority rule is designed to vindicate the reasonable expectations formed by claimants when their investments or loans were made [citations omitted]. In the instant case, those expectations will not be vindicated — instead, they will be violated — by allowing rescission and reclamation. Kelce is in reality seeking relief from the general unsecured creditors of the corporation. Because of USF's insolvency and ultimate liquidation, the percentage which the general creditors would realize would be reduced were Kelce allowed to rescind and reclaim. The absolute priority rule will not tolerate this eventuality. [citations omitted]
>
> * * *
>
> "[W]e conclude that the absolute priority rule would be rendered meaningless were we to allow Kelce to rescind and reclaim. The context of the instant case is crucial to our holding; when all are defrauded, it is

manifestly unfair to allow one shareholder to benefit from that fraud at the others' expense." (Appendix, pp. 22, 28-29, 32-33.)

Certiorari Should Be Denied.

1. There Is Absolutely No Conflict Whatsoever Between the Decision of the Court of Appeals and This Court's Decision in *Pearlman v. Reliance Insurance Company*, 371 U.S. 132 (1962).

Petitioner again makes the claim that the result reached in the present case conflicts with this Court's decision in *Pearlman v. Reliance Insurance Company*, 371 U.S. 132 (1962). This argument was previously presented to each of the Courts below, and was rejected by all of them. As the Ninth Circuit observed in this regard:

> "Kelce cites several cases in support of his claim for rescission and reclamation. As the District Court noted, however, none of these cases addressed the interaction between the absolute priority rule and the common law right of rescission in Chapter X proceedings. As such, none is controlling here.
>
> "In *Pearlman v. Reliance Insurance Co.*, 371 U.S. 132 (1962), the Supreme Court held that the debtor's surety was entitled to recover funds specifically set aside to secure the surety's obligation. The debtor had no *colorable* ownership claim to the funds in question, thus the trustee never obtained title at all. Moreover, *Pearlman* involved an ordinary bankruptcy, and thus the Court was not presented with an opportunity to discuss the absolute priority rule, or a shareholder's right to rescission and reclamation in the context of a Chapter X reorganization." (Appendix, p. 26) (Emphasis in original.)

Thus, petitioner's assertion that the result reached below "conflicts" with *Pearlman*—a case which did not even arise under Chapter X and which did not in any respect consider

the interplay between the "absolute priority rule" and the common law right to rescission and reclamation (which is the very essence of the dispute here)—is completely unfounded and totally lacking in merit.

Indeed, not only does the result reached below *not* conflict with this Court's opinion in *Pearlman*, but it also is entirely consistent with the only other reported case to consider the point, *Matter of Stirling Homex*, 579 F.2d 206 (2d Cir. 1978), *cert. denied sub nom. Jezarian v. Riache*, 439 U.S. 1074 (1979).

In *Stirling Homex*, the Second Circuit characterized the issue for decision as "[w]hether persons who were allegedly induced by fraud to purchase Homex stock should be allowed, in a reorganization proceeding, to assert claims in such a way as to achieve parity with ordinary unsecured tort and contract claimants." 579 F.2d at 211. The Second Circuit held (as the Courts below in the instant case have held) that no such parity could be allowed without violating the "absolute priority rule."

In reaching this result, the Court relied on the allocation of risk analysis formulated by Professors Slain and Kripke in their much-cited article, *The Interface Between Securities Regulation and Bankruptcy - Allocating the Risk of Illegal Securities Issuance Between Security Holders and the Issuer's Creditors*, 48 N.Y.U.L.Rev. 261 (1973) which, as explained by the Court, takes into account that

> ". . . there are two entirely distinct types of risks taken by creditors and investors when they decide to do business with a corporation: the risk of insolvency of the debtor and the risk of the unlawful issuance of securities. . . . It is appropriate that both the general creditors and the investors assume the risk of insolvency. As between the creditors and the investors, however, only the investors should be forced to bear the risk of

illegality in the issuance of stock.

"In theory, the general creditor asserts a fixed dollar claim and leaves the variable profit to the stockholder; the stockholder takes the profit and provides a cushion of security for payment of the lender's fixed dollar claim. The absolute priority rule reflects the different degree to which each party assumes a risk of enterprise insolvency; no obvious reason exists for reallocating that risk. . . . [I]t is difficult to conceive of any reason for shifting even a small portion of the risk of illegality in the stock issuance from the stockholder, since it is to the stockholder, and not the creditor, that the stock is offered." 579 F.2d at 214.

See also Huff, *The Defrauded Investor in Chapter X Reorganizations: Absolute Priority v. Rule 10b-5*, 50 Am. Bankr. L.J. 197 (1976).

2. No Significant or Recurring Problems of Practical Importance Are Presented by This Case Since Congress, by Enacting Section 510(b) of the Bankruptcy Reform Act of 1978, 11 U.S.C. § 510(b), Has Now Statutorily Provided for the Result Reached by the Court of Appeals Below.

Petitioner contends that "[t]he decision below raises significant and recurring problems of considerable practical importance in the administration of both the Bankruptcy Act and the Bankruptcy Code." *See* Petition for Writ of Certiorari, p. 8. Whatever force this contention may have had prior to the passage of the Bankruptcy Reform Act of 1978, it has absolutely no validity now.

Section 510(b) of the Bankruptcy Reform Act, 11 U.S.C. § 510(b), now statutorily provides for the exact result reached by the Court of Appeals below and reached by the Second Circuit in *Stirling Homex*. Section 510(b) expressly provides that

> "Any claim for rescission of a purchase or sale of a security of the debtor or of an affiliate or for damages arising from the purchase or sale of such a security *shall be subordinated for purposes of distribution to all claims and interests that are senior or equal to the claim or interest represented by such security.*" (Emphasis supplied.)

As the Senate Report on the Bankruptcy Reform Act has noted, where, as here, the security held by the rescission claimant "is an equity security, the damages or rescission claim is [therefore] *subordinated to all creditors and treated the same as the equity security itself.*" Senate Report No. 95-989, 1978 U.S. Congressional and Administrative News, p. 5860. (Emphasis supplied.) Thus, since Section 510(b) requires that all rescission claims relating to an equity security be subordinated to the claims of the general unsecured creditors, and since allowance of Kelce's rescission and reclamation claim would effectively "transform his claim as a defrauded shareholder into a secured claim,"[3] the result reached below by the Court of Appeals in considering the "absolute priority rule" is now expressly mandated by Section 510(b). (Appendix, pp. 28, 41.)

Moreover, it is no help to petitioner to speculate that questions similar to those presented in this case may possibly arise in the wholly unrelated context of an express trust agreement or the sale of goods under the Uniform Commercial Code. *See* Petition of Writ of Certiorari, pp. 9-10. The short answer to this contention is that the adjudication of any such questions, should they ever arise, can only be made in connection with a case which *actually presents* such points for decision—and not in the present case which has

---

[3]The security would, of course, be the assets reclaimed from the estate.

absolutely nothing whatsoever to do with either an express trust agreement or the sale of goods under the U.C.C.

As this Court has long noted, "it is very important [to] be consistent in not granting the writ of certiorari except in cases involving principles the settlement of which is important to the public, as distinguished from that of the parties. . . ." *Rice v. Sioux City Memorial Parks Cemetery*, 349 U.S. 70, 79 (1955). In light of the enactment of Section 510(b) of the Bankruptcy Reform Act of 1978, which effectively settles this dispute for all future cases, the instant case can not possibly be deemed to present any important or recurring problems of any practical significance whatsoever to the proper administration of the federal bankruptcy laws.

Conclusion.

For all of the foregoing reasons, a Writ of Certiorari to review the judgment and decision of the United States Court of Appeals for the Ninth Circuit should be in all respects denied.

DATED: April 8, 1981.

Respectfully submitted,

RIFKIND & STERLING, INCORPORATED,
By WILLIAM G. WILSON, ESQ.,
JAYSON BURTON LUMISH, ESQ.,
/s/WILLIAM G. WILSON,
Counsel for Respondents.